There are four primary methods of billing clients for financial products and services; commission on sales of products and services, a percentage of the assets under management (AUM), a fee-only structure based on the specific needs of the client, and a hybrid of fees and commissions. Each billing method offers advantages and disadvantages for the client and the professional. In this paper I will outline the specific differences of each billing method and then compare each based on the criteria of ethics. According to Jerry Geiger author of, White Noise: Is the Never-Ending Dialogue About Fees Versus Commissions Harming the Financial Planning Profession, the ethical issue is that of providing advice that is in the best interests of the client at all times.

The oldest and most common fee structure, used by 65% of all financial planners, is commission based on the sale of financial products and services (3). Commissions are generally assessed as a percentage of the total transaction. Products and services which are more lucrative for the firm may result in higher commissions while less profitable products and services result in lower commissions for the planner. This is where the conflict of interest occurs for most commission compensated financial planners. Planners may be tempted to advise their clients to make unwarranted moves from product to product or purchase a product or service that is unwise but results in a larger commission for the planner. Fee-based financial planners feel this conflict of interest, the best advice for the client versus and the best commission for the financial planner, can be eliminated by moving to a fee only structure. Commission based planners have their own position which will be discussed in the following paragraph.
Although fee-based planners currently represent approximately 23% of all financial planners in the market, their popularity is growing rapidly (3). The reasons for this are two fold: The Certified Financial Planner® (CFP®) Board of Standards is promoting fee based compensation for financial planners as the ethical fee structure to potential clients. Additionally, the CFP® Board is encouraging fee based planning in the CFP® community by leveraging the use of its trademark, the most widely recognized financial planning designation in the world (3). Without the proper disclosure of fees required by the CFP® Board, planners cannot use the trademark or the designation. Rick Adkins, CFP® and senior partner at Adkins and Associates, described his transition to fee-based planning; “We got tired of swimming upstream. Every publication that our clients picked up was saying ‘go to a fee-based planner.’ We either had to change our clients or change our compensation structure.” (3) This is just one example of the influence the CFP® Board has had on the fee structure of the planning community.

The CFP® board requires the disclosure of fees to clients that fee based planning allows (2). It is relatively easy to explain to a client that you will pay a set fee for each product or service that you request. It can be more difficult to sell the concept that a client pays a fee as a percentage of each sale regardless of the level of service that they require or desire. Although it seems that fee based planning is the clear choice, there are many studies that demonstrate a client must have a significant amount of assets before the fee based structure provides a lower cost to the client. This is a function of economies of scale. Consider the following; firm may charge a flat rate of $500 to rebalance a client’s portfolio
to the level of risk that they are comfortable with and that is appropriate for their investment horizon. If the client has a million dollars in assets, this equates to a .05% fee based on total assets. If you consider the more likely scenario, that the client has $100,000 in assets, the fee becomes .5%, which is a tenfold increase relative to the million dollar client. Now assume that the firm changes to charging a flat ¼ % fee to rebalance each portfolio. The table below outlines the results.

Table 1: Comparison of fee based vs. commission based fee structures.

<table>
<thead>
<tr>
<th>Client</th>
<th>Portfolio Value</th>
<th>Flat Fee</th>
<th>.25% of Total</th>
<th>Flat Fee as % of Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>El Richo</td>
<td>$1,000,000</td>
<td>$500</td>
<td>$2,500</td>
<td>0.05%</td>
</tr>
<tr>
<td>Sammy Saver</td>
<td>$100,000</td>
<td>$500</td>
<td>$250</td>
<td>0.50%</td>
</tr>
<tr>
<td>Ends Meet</td>
<td>$10,000</td>
<td>$500</td>
<td>$25</td>
<td>5.00%</td>
</tr>
<tr>
<td>Total</td>
<td>$1,500</td>
<td>$2,775</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The incentive for the firm to use commission based fees: $1,275

Given the results of Table 1, the question for the financial planner then becomes the following: ‘What is more ethical?’ charging a different rate for the same service and level of effort, or charging a flat rate of $500 per portfolio rebalance where a low net worth client is paying five percent of their portfolio value for the service?

An alternative to a fee-based structure that is slightly different from traditional commissions is the assets under management approach (AUM). With the AUM fee structure, the client is charged a set percentage for all the financial services that they require annually. This is different from a
commission based structure that charges a percentage based on sales of a product or service. As previously noted, commission based fees may cause a financial planner to provide advice on a product or service that is not in the best interest of the client. With the AUM approach, the firm is managing the financial assets of the client and there is no incentive to sell products and services that they do not need, although other ethical dilemmas are present as noted in the following paragraph. Many feel that this is the best approach due to the inherent incentive that this system possesses. Consider that if a firm manages a client’s financial assets well, the firm will increase the value of those assets over time. With the increase in value, the client gains more wealth and the firm gets greater compensation through the AUM fee structure. Clients appreciate this method from a risk standpoint because they know the amount that they will pay their financial planner in fees for financial services.

Until recently, the AUM management fee structure was seen as a more ethical alternative to fee- based financial planning. Bert Whitehead, in his article titled, “AUM Under Fire: The Advisor’s Quandary: How to Construct an Ethical Fee Arrangement” notes the following ethical problems with the AUM fee structure (1):

- The adviser recommends the asset allocation for a client's portfolio, following the standard practice of charging a higher rate for stocks (1.5% of assets) than for bonds (0.5%). This creates a strong bias to overweight equities.
- The adviser's suggestions about whether to buy or sell real estate and how much to mortgage are tainted by self-
interest. It is to the adviser's advantage to keep assets in portfolios, not in dwellings.

- The client's decision to gift to children or contribute to charities affects the amount of assets under management.
- People do what they're paid to do. To the extent they're paid to manage assets, they concentrate there. As a result, they skimp on comprehensive planning.
- When the adviser discloses potential conflicts in the AUM model to the client, the adviser diminishes his credibility.
- During the bear market, many firms suffered from high fixed operating costs while repositioning assets in fixed income, thereby reducing their profit margin. About 30% of AUM firms went under at the time, in part, because they did the right thing for clients.
- AUM advisers are not compensated for other related financial advice.
- Clients are averse to disclosing all of their assets to avoid pressure to consolidate accounts.
- AUM often does not offer full disclosure to clients (e.g., an advisor's quarterly statement does not clearly note the fee).

Finally, there are some firms that are trying to develop a fee structure that is more suited to the product or service being provided. These firms are trying what is know as a hybrid fee structure where the sale of some products and services result in compensation through commission while other products and services are fee based. The fundamental and ethical problem with this approach is that although the firm's intention is to
develop a fee-based structure that is more appropriate, it has made the fee structure more complex creating less understanding for the client. This fee structure has been relatively unsuccessful do to complexities and the clients’ perception of hidden fees.

The most appropriate and logical fee structure for financial planners is the fee-based method. The fee for service method is the current en vogue method and there is not a foreseeable change in this trend. Likewise, the fee for service method continues to become more popular as more clients gain an understanding of this type of fee structure. The fee for service method allows financial planners to meet the disclosure requirements required by the CFP® Board and provide their clients with a simple easy-to-understand fee structure. Likewise, it gives the planner an opportunity to sell services and be rewarded for their efforts. The current flat rate fee may need to be revisited to ensure that those clients with relatively small portfolios are not paying excessive fees for products and services. Inevitably, I would expect a swing in fee structure commonality where the fee for service structure will become predominant.

The ethical decisions made by financial planners are not a direct result of the fee structure that the financial planner will be compensated under. There are compensation arrangements that tend to provide more incentive to the financial planner to give advice that is not always in the best interest of their clients. Having said that, there are thousands of financial planners operating under these arrangements daily that choose the ethical high road and only give advice that they believe is in the best interest of their clients. There are fee structures
that have tried to remove the ethical dilemma faced by financial planners only to convolute the client’s perception of the fee structure. Likewise, removal of the reward for performance for financial planners may cause the talent of the organization to leave. In the end, ethical decisions are made by people, not systems or processes. Forming a trusting long-term relationship with your financial planner is the best “fee” structure that can be designed and hoped for.
Sources Cited:

